Internal Revenue Service

# memorandum

CC:TL-N-9144-89
Brl:HMLewis

date: SEP 20 1989

to: District Counsel, Washington, D.C. CC:WAS
Attn: Warren P. Simonsen, Assistant District Counsel

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [redacted] v. Commissioner, ([redacted]), Docket No. [redacted]

This is in response to your supplemental request dated May 9, 1989, for Tax Litigation Advice with respect to the above-named taxpayer. On May 15, 1989, you requested further Tax Litigation Advice with respect to this taxpayer concerning whether the consents to extend the period of limitations executed with respect to [redacted] were valid.

It was agreed that your request of May 9, 1989, would be suspended pending resolution of your request of May 15, 1989. In a letter dated August 15, 1989, we advised you that the consents in question were valid. Accordingly, we have reopened your request and furnish the following Tax Litigation Advice.

## ISSUES

1. Whether the guarantee dated [redacted], of certain nonrecourse liabilities caused those liabilities to be treated as recourse liabilities for purposes of I.R.C. 752. 0752-0100, 0752-0200.

2. Whether, under the facts as presented below, section 704(b) provides authority to disallow loss allocations to the limited partners after their capital accounts have been reduced to zero. 0704-0100, 0704-0200.

## CONCLUSIONS

1. Because a general partner of [redacted] is ultimately liable on the indebtedness of the nonrecourse liabilities because of the guarantee, the liabilities will be treated as recourse liabilities for purposes of section 752 as of the date of the signing of the guarantee.

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2. The regulations under section 704(b) provide that such loss allocations to the limited partners lack economic effect. Accordingly, the losses should be reallocated from the limited partners to the general partners.

## FACTS

[redacted] was organized in [redacted] primarily to develop, construct, and operate a commercial office building and hotel in [redacted], Florida. The general partners contributed $[redacted]. The limited partners contributed capital of $[redacted], which consisted of [redacted] units at $[redacted] per unit. For each unit, only $[redacted] was payable upon execution of the partnership agreement. The remaining $[redacted] was evidenced by promissory notes payable on [redacted] ($[redacted]), [redacted] ($[redacted]), and [redacted] ($[redacted]).

Through [redacted], [redacted] accumulated total nonrecourse debt of $[redacted] and, in [redacted], [redacted] borrowed an additional $[redacted] on a recourse basis. [redacted] incurred net losses of approximately $[redacted] between [redacted] and the end of [redacted]. Because the partnership agreement allocated [redacted] percent of these losses to the limited partners, their capital accounts reflected large deficit balances.

In [redacted], as a condition for extending a recourse loan to [redacted], the [redacted] required the guarantee executed on [redacted], on the existing nonrecourse liabilities. By the end of [redacted], recourse loans independent of the guaranteed nonrecourse loans totaled $[redacted].

On [redacted], the Guarantee of Payment was signed in the following manner by [redacted]:

[redacted]

[redacted] general partner

[redacted],

general partner

By:

[redacted], President

Attached to the Guarantee of Payment are two statements by a New York Notary Public. They state in pertinent part that [redacted] is known to the Notary Public:

> to be the President of [redacted], a corporation, general partner of [redacted], a partnership; and acknowledged to me that he executed the same on behalf of the partnership.
>
> to be the [a] general partner of [redacted], a partnership, and acknowledged to me that he executed the same for the purposes and consideration therein expressed and as and in the capacity therein stated.

[redacted] holds a [redacted] percent general partnership interest in [redacted]. [redacted] is a wholly-owned subsidiary of [redacted] of which [redacted] is an [redacted] percent shareholder. (The owner of the remaining [redacted] percent interest has not been determined.) [redacted] owns a [redacted] percent combined general and limited partnership interest in his individual capacity in [redacted]. [redacted] owns a [redacted] percent interest in [redacted]. [redacted], in his individual capacity, owns the remaining [redacted] percent.

In addition to the guaranteed nonrecourse loans, recourse loans in [redacted], [redacted], and [redacted], [redacted] sustained operating losses of $[redacted], $[redacted], and $[redacted], respectively, which the partnership agreement again allocated [redacted] percent to the limited partners. The [redacted] filed a foreclosure action, but the [redacted] ultimately acquired the property in [redacted], in a forced sale resulting from the bankruptcy reorganization.

[redacted]'s partnership agreement provides for both "capital accounts" (section 3.01(h)) and "cash accounts" (section 3.01(i)). A partner's capital account is defined as the partner's cash contributions increased by allocated net income and decreased by distributions and allocated net losses. A partner's cash account is defined as the partner's cash contributions decreased by distributions. Thus, the principal difference between a capital account and a cash account is that the latter is not adjusted for allocations of net income and losses.

The partnership agreement (section 3.02) generally allocates net income and losses [redacted] percent to the limited partners and [redacted] percent to the general partners. Specifically, operating income and losses are allocated [redacted] percent to the limited partners until the taxable year following the year in which limited partner cash accounts reach zero. Thereafter, the allocation is [redacted] percent to the limited partners and [redacted] percent to the general partners.

Capital transaction net income is allocated [redacted] percent to the limited partners until an amount has been allocated that equals the sum of their deficit capital accounts (if any) and their cash account balances. Additional capital transaction net income is allocated [redacted] percent to the general partners under the same formula. Any remaining capital transaction net income is allocated [redacted] percent to the limited partners and [redacted] percent to the general partners. Capital transaction net losses, in contrast, are allocated [redacted] percent to the limited partners and 1 percent to the general partners.

The partnership agreement (section 3.03) provides that distributions of net cash flow begin, at the earliest, in [redacted]. Until limited partner cash accounts are zeroed out, net cash flow is distributed each taxable year based on the following priority scheme: (1) in the form of a cumulative preferred return to each limited partner, computed as [redacted] percent of the partner's current cash account; (2) to the general partners in an amount equal to that paid to the limited partners, not to exceed $[redacted] in any year; (3) [redacted] percent to the limited partners and [redacted] percent to the general partners. After the cash accounts of the limited partners have been reduced to zero, net cash flow is distributed [redacted] percent to the limited partners and [redacted] percent to the general partners.

Section 3.04 of the partnership agreement provides a different distribution pattern for "excess funds," defined as cash generated by the sale, refinancing, or insured loss of the partnership's real property. After the repayment of partner loans and remaining cash accounts, excess funds are distributed [redacted] percent to the limited partners and [redacted] percent to the general partners. According to section 3.04(c), if, at the time of a distribution of nonrefinancing excess funds, any partner has a negative capital account:

> [A]n amount otherwise distributable to such Partner up to the amount of such negative Capital Account shall not be distributed to such Partner but shall be (i) credited to the Partner's Capital Account and (ii) distributed in accordance with this paragraph as additional Excess Funds which are part of the same distribution for purposes of determining distribution priorities hereunder.

Distributions upon dissolution and termination of the partnership are covered by section 3.05 of the partnership agreement. Apart from priority items peculiar to partnership liquidations, such as liquidation expenses and payment of creditors, liquidation proceeds are distributed in essentially the same manner as excess funds, including the adjustment for negative capital accounts at the time of distribution.

## LEGAL ANALYSIS

ISSUE 1. Effect of Guarantee

Section 752(a) provides that any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.

Section 752(b) provides that any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

Treas. Reg. 1.752-1(e) provides that a partner's share of partnership liabilities shall be determined in accordance with his ratio for sharing losses under the partnership agreement. In the case of a limited partnership, a limited partner's share of partnership liabilities shall not exceed the difference between his actual contribution credited to him by the partnership and the total contribution which he is obligated to make under the limited partnership agreement. However, where none of the partners has any personal liability with respect to a partnership liability, then all partners, including limited partners, shall be considered as sharing such liability under section 752(c) in the same proportion as they share the profits.

In the example following Treas. Reg. 1.752-1(e), G, the general partner, and L, the limited partner, make equal contributions of $20,000 cash to the partnership GL. Under the terms of partnership agreement, they are to share profits equally but L's liabilities are limited to the extent of his liabilities. Subsequently, the partnership pays $10,000 for real property which is subject to a mortgage of $5,000. Neither the partnership nor any of its partners assume any liability on the mortgage. The basis of the property to the partnership is $15,000. The example concludes that the basis of G and L for their partnership interest is increased by $2,500 because each partner's share of the partnership's liability (the $5,000 mortgage) has increased by such amount. However, if the partnership had assumed the mortgage so that G had become personally liable, G's basis for his interest would have increased by $5,000 and L's basis would remain the same.

Treas. Reg. 1.752-1(a)(2) discusses a situation in which equal partnership AB owns real property with an adjusted basis to the partnership of $1,000, a fair market value of $800, and which is subject to a $400 mortgage that the partnership has not assumed. The regulation states that under the operation of section 752(a) and section 752(c), a $200 increase because of that mortgage is reflected in the basis of each partner under section 722. The regulation further states that if the real property is distributed by the partnership to A, the basis of B's partnership interest is decreased by $200 because the distribution of the real property to A resulted in a decrease in B's share of partnership liability under section 752(b).

Thus, in situations in which no partner has any personal liability with respect to a partnership liability, all partners, including the limited partners, will share in that liability and each partner's basis will reflect his share of the liability. But if any partner has any personal liability with respect to that liability, then the limited partners will not share in that liability, except to the extent such limited partners have additional obligations to contribute. Furthermore, if a general partner later guarantees a liability for a nonrecourse debt, the limited partners that received basis with respect to that nonrecourse liability must reduce their basis to the extent that the general partner has guaranteed the indebtedness.

It is not clear from the signature lines of the guarantee whether [redacted] is signing as a general partner of [redacted] or [redacted]. From the language in the notarized statement, it would appear that [redacted] intended to sign as a general partner of [redacted]. This point may be clarified in the documents used by the [redacted] in its litigation to collect on the guarantee. This memorandum will discuss both possibilities.

A. [redacted] Signed As A General Partner of [redacted]

If it can be shown that [redacted] signed the guarantee as a general partner of [redacted], the following argument applies.

The leading case applying Treas. Reg. § 1.752-1(e) to a guarantee by a general partner is Raphan v. United States, 3 Cl. Ct. 457 (1983), rev'd, 759 F.2d 879 (Fed. Cir. 1985). In Raphan, the United States Court of Appeals for the Federal Circuit held that the guarantee of an otherwise nonrecourse liability by general partners causes the liability to be treated as a recourse liability for purposes of section 752. See also, Rev. Rul. 83-151, 1983-2 C.B. 105.

In the instant case, [redacted] was a general partner in [redacted] at the time the guarantee was signed. [redacted] signed the guarantee for [redacted] in its capacity as a general partner of [redacted]. Therefore, based on the above, as of the date of the signing of the guarantee, the liabilities will be treated as recourse for purposes of section 752.

B. [redacted] And [redacted] Signed As General Partners of [redacted]

If it is determined that [redacted] and [redacted] signed as general partners of [redacted], the following argument applies. Even if it is determined that Argument A above is applicable, Argument B should be made in the alternative.

The nonrecourse liabilities should be treated as recourse after the signing of the guarantee regardless of the capacity in which [redacted] and [redacted] signed the guarantee. While section 707 recognizes that a partner may act in a capacity other than as a partner, the regulations under section 752 contain no such distinction. To the contrary, the regulations provide that limited partners may share in a partnership liability only "where none of the partners have any personal liability with respect to . . . [that] liability." "Personal liability" with respect to a debt simply means that all of the debtor's assets may be reached by the creditor if the debt in question is not paid. See Laney v. Commissioner, T.C. Memo. 1979-491, aff'd on this issue, 674 F.2d 342 (5th Cir. 1982).

In the instant case, both [redacted] and [redacted]s assets are available to satisfy the guarantee. Those assets include their partnership interests in [redacted]. Therefore, it is in fact the assets of general partners of [redacted] to which the creditor will ultimately be able to look to satisfy the debt. The fact that [redacted] is not a partner in [redacted] does not preclude the Service from asserting this position as form should not govern substance. See McKee, Nelson & Whitmire, Federal Taxation of Partnerships and Partners ¶ 8.02[3] 1977.

> Arguably, since the guarantor is not a partner, the nonrecourse liability definition has been satisfied. No "partner" has any personal liability for the debt.
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> Despite technical compliance with the definition, most seasoned tax practitioners are apt to have misgivings about this approach. Even if the corporate general partner is a substantial entity, formed for valid business reasons unrelated to the matter at hand, the transaction is vulnerable to attack on the theory that a guaranty by a shareholder of the general partner means the shareholder's assets, including its shares of the corporate general partner, are available to satisfy the guaranty. Through these shares in the general partner, the guaranteed creditor will ultimately be able to look to the assets of the general partner to satisfy the debt, just as if the general partner had guaranteed the debt directly. The shareholder's guaranty can thus be viewed as a guaranty by both the

shareholder and the general partner, and if so viewed, it is a violation of the nonrecourse liability rules.

This theory is supported by the emphasis placed on ultimate liability in case law. In Abramson v. Commissioner, 86 T.C. 360 (1986), a limited partner guaranteed payment of his pro rata portion of a nonrecourse note in the event the partnership defaulted. The court concluded that because the note was nonrecourse, the limited partner could not seek reimbursement from the general partners in the event he was called upon to pay a pro rata portion of the note. Under these circumstances, each limited partner is obligated to use his personal assets to satisfy, pro rata, the partnership liability. Therefore, in effect, the limited partners are the equivalent of the general partners to the extent of their pro rata guarantees.

Similarly, in Melvin v. Commissioner, 88 T.C. 63, 75 (1987) appeal docketed, No. 87-7377 (9th Cir. 1987), the Tax Court stated that recent cases establish that with respect to a particular debt obligation, a partner will be regarded as personally liable within the meaning of section 752 (for basis purposes) if he has ultimate liability to repay the debt obligation of the partnership in the event funds are not available for that purpose. The Tax Court cited Raphan v. United States, 759 F.2d 879, 886 (Fed. Cir. 1985); Abramson v. Commissioner, 86 T.C. 360, 375-376 (1986); Gefen v. Commissioner, 87 T.C. 1471 (1986); and Smith v. Commissioner, 84 T.C. 889, 907-908 (1985), aff'd. without published opinion, 805 F.2d 1073 (D.C. Cir. 1986).

The Tax Court found ultimate liability as the sole criterion for receiving basis under section 752, regardless of whether the liability is direct. The court determined that the relevant question is who, if anyone, will ultimately be obligated to pay the liability if the partnership is unable to do so. The fact that the partnership or other partners remain in the "chain of liability" is irrelevant. In determining who has the ultimate economic responsibility for the loan, the substance of the transaction controls. Melvin, 88 T.C. at 75.

The substance of the guarantee by [redacted] supports a finding that the liabilities should be treated as recourse for purposes of section 752. [redacted] was not an unrelated third party guarantor and the guarantee was not an arm's length transaction. But for the interest of [redacted] and [redacted] in [redacted] there appears to be little economic reason for [redacted] to guarantee the liabilities of [redacted]. If the guarantee by [redacted] does not result in the liability being recourse for purposes of section 752, form over substance will prevail and allow [redacted] and [redacted] to do indirectly what they could not have done directly.

ISSUE 2 Economic Effect of Allocations

Section 704(b) provides that a partner's distributive share of income, gain, loss, deduction, or credit is determined in accordance with the partner's interest in the partnership if the allocation does not have substantial economic effect.

The determination of whether an allocation has substantial economic effect involves a two-part analysis. First, the allocation must have economic effect. Second, the economic effect of the allocation must be substantial.[1] Treas. Reg. § 1.704-1(b)(2)(i).

An allocation to a partner will have economic effect if, and only if, throughout the full term of the partnership, the partnership agreement provides: (1) for the determination and maintenance of the partners' capital accounts in accordance with the regulations; (2) upon liquidation of the partnership (or any partner's interest in the partnership), liquidating distributions are required in all cases to be made in accordance with the positive capital account balances of the partners; and (3) if such partner has a deficit balance in his capital account following the liquidation of his interest in the partnership, he is unconditionally obligated to restore the amount of the deficit balance to the partnership. Treas. Reg. § 1.704-1(b)(2)(ii)(b).

Despite the absence of a deficit makeup obligation for limited partners in the [redacted] partnership agreement, we stated in our memorandum dated August 24, 1988, that loss allocations up to the amount of their cash contributions should not be challenged. Whether or not there is a legitimate "qualified income offset" here (Treas. Reg. § 1.704-1(b)(2)(ii)(d)) that will substitute for a missing deficit makeup obligation, it seems clear that the limited partners' interest in the partnership with respect to these losses would permit the allocations. See Treas. Reg. § 1.704-1(b)(3); W. McKee, W. Nelson & R. Whitmire, Drafting, Amending, and Analyzing Partnership Agreements under the New Partnership Allocation Regulations 19 (1986).

A. Determination and Maintenance of Capital Accounts

We note, however, that the limited partners initially contributed only a portion of their $[redacted] total capital in

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[1] We do not address the substantiality of the subject allocations in this memorandum. We stated in our memorandum dated August 24, 1988, that, absent additional factual information, a meaningful analysis of this matter is not possible. Provided that the allocations are deficient on economic effect grounds, the substantiality assessment is irrelevant.

cash, the remainder being evidenced by promissory notes. Although the partnership agreement (section 3.01(g)) treats unpaid notes as "cash contributions," thus including the unpaid principal in capital accounts, the regulations provide otherwise. Under Treas. Reg. § 1.704-1(b)(2)(iv)(d)(2), contributed notes generally increase a partner's capital account only when the partnership makes a taxable disposition of the note or when the partner makes principal payments.[2] Therefore, we recommend that you determine the timing and extent of payment on the notes prior to conceding the full $[redacted] of loss allocations.[3]

B. Liquidation Proceeds Following Positive Capital Accounts

We have considerable doubts that the [redacted] partnership agreement satisfies this second element of economic effect. Most fundamentally, the partnership agreement (section 3.05(a)(4) and section 3.04(a)(3) and (4)) expressly provides that liquidation proceeds will correspond to cash accounts rather than capital accounts. As already noted, cash accounts do not include adjustments for income and loss allocations.

In addition, the adjustment provisions in the partnership agreement that supposedly ensure distributions in accordance with positive capital accounts[4] appear to be unworkable. As described earlier, the partnership agreement provides that liquidating distributions will not be made to a partner with a deficit capital account. Instead, the partner's capital account will be credited with the distribution amount and the freed-up cash will go back into the distribution pool. This appears to be a deemed

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[2] An exception, presumably not applicable here, applies to notes readily tradable on an established securities market. Even if not included in the partner's capital account, a note's unpaid principal balance may still support a loss allocation if the outstanding balance is treated as an obligation to restore a deficit capital account. See Treas. Reg. § 1.704-1(b)(2)(ii)(c). To come within this beneficial provision, however, a note "is required to be satisfied at a time no later than the end of the partnership taxable year in which such partner's interest is liquidated (or, if later, within 90 days after the date of such liquidation)."

[3] See infra note 9. We note that the last promissory note in the amount of $[redacted] for each limited partner was due [redacted]. Thus, it appears that a limited partner should not have received any basis for that note until it was paid.

[4] See [redacted]'s submission dated [redacted], at 5.

distribution followed by a deemed recontribution.[5] However, any such distribution-recontribution would not result in a net "credit" (i.e., positive movement) to the partner's capital account, but would leave the capital account unchanged.[6]

These adjustment provisions in the partnership agreement may have been the drafter's attempt to create some form of valid "Class B" liquidating provision, as described by the authors of a leading treatise on partnership taxation.[7] The adjustment provisions arguably reach that result if a liquidating distribution drives a positive capital account negative. In this positive-becomes-negative situation, however, the adjustment provisions literally do not come into play because the partnership agreement premises the adjustments on a partner having a negative capital account <u>at the time</u> of the

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5 Indeed, the transaction is characterized this way by [redacted]'s submission dated [redacted] at 5.

6 Treas. Reg. § 1.704(b)(2)(iv)(<u>b</u>) plainly provides for a capital account decrease in the case of a cash distribution and a capital account increase in the case of a cash contribution.

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> [T]he net economic results of a Class B liquidating provision are also identical to the economic results produced by a [provision that requires liquidation proceeds to follow positive capital accounts]. This is because the deficit makeup requirement undoes any disparities between the partners' capital accounts and the initial distributions they receive under a Class B provision. In other words, partners who initially receive more than their capital account balances will be required to recontribute amounts equal to their resultant deficit capital accounts; these amounts will then be available for distribution and will exactly satisfy the resultant positive capital accounts of the partners who initially receive less than their capital account balances. In view of the lack of any significant economic differences between a Class B provision and a capital account provision, it seems the two types of provisions should have essentially the same income tax consequences, a result that is confirmed by the § 704(b) Regulations.

R. Whitmire, W. Nelson, W. McKee & M. Kuller, <u>Federal Taxation of Partnerships and Partners</u>, Vol. 3, ¶ 6.02[2] at 6-11 (1989).

distribution, not because of the distribution. If the partner already has a negative capital account at the time of the distribution, the adjustment provisions literally apply but, as described in the preceding paragraph, they have no apparent capital account effect.

C. Obligation to Restore a Deficit Balance

Regarding this third element of economic effect, [redacted] concedes that the partnership agreement lacks a deficit makeup requirement for the limited partners.[8] [redacted]'s [redacted] taxable year becomes the primary focus for limited partner loss allocations because in that year limited partner capital accounts drop to significant negative balances.[9]

D. Nonrecourse Deductions and Minimum Gain

At the end of [redacted], [redacted] had outstanding nonrecourse liabilities of $[redacted] and outstanding recourse liabilities of $[redacted]. The [redacted] property that secured these debts had an adjusted basis to [redacted] of $[redacted]. With respect to the "minimum gain" issue, we concluded in our memorandum dated August 24, 1988, that, assuming the recourse debt was subordinated to the nonrecourse debt, there would be no increase in partnership minimum gain because of the stacking rule in Treas. Reg. § 1.704-1(b)(4)(iv)(c). Accordingly, the limited partners could not benefit from the regulations' nonrecourse deduction safe harbor. We assume that the recourse debt was indeed subordinate to the nonrecourse debt because, from a business standpoint, the lender is better off under these circumstances.[10] In addition, [redacted] concedes, in its submission dated [redacted], that the minimum gain safe harbor is not technically applicable.

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8 See [redacted] submission dated [redacted].

9 Actually, some capital accounts could have gone negative as early as [redacted] if contributed notes were not paid when due. Moreover, even if all notes were paid when due (and not earlier), all limited partner capital accounts would have become negative in [redacted]: at the end of that year, cumulative allocated losses exceeded the sum of contributed cash and principal paid on notes. See first paragraph of Facts on page 2 and text accompanying note 2.

10 This presumes that the [redacted] was also the recourse lender, as stated in [redacted]'s memorandum to [redacted] dated [redacted] (item A.6.).

E. Partners' Interests in the Partnership

If an allocation does not have economic effect, the allocated amount is reallocated for tax purposes in accordance with the partners' interests in the partnership. Section 704(b); Treas. Reg. § 1.704-1(b)(1)(i). If the original allocation lacks economic effect because there is no applicable deficit makeup requirement, then the partners' interests in the partnership are generally determined under Treas. Reg. § 1.704-1(b)(3)(iii). This provision applies only if liquidating distributions correspond to positive capital accounts. See Treas. Reg. § 1.704-1(b)(3)(iii)(a). As discussed above, we do not believe this to be the case. Nonetheless, a court may interpret the partnership agreement to require liquidating distributions to follow positive capital accounts, in which case this provision literally applies. Even if the provision does not literally apply based on our analysis of liquidating distributions, we believe that the principles of Treas. Reg. § 1.704-1(b)(3)(iii) are broadly applicable to the general partners'-interest-in-the-partnership inquiry.

Treas. Reg. § 1.704-1(b)(3)(iii) provides that the partners' interests in the partnership are determined by, first, establishing how distributions (and contributions) would be made if all partnership property were sold at book value and the partnership were liquidated immediately following the end of the taxable year to which the allocation relates. This result is compared to the result of the same hypothetical sale and liquidation for the prior taxable year.

Based on this analysis, as illustrated by Example 15 in Treas. Reg. § 1.704-1(b)(5), the $[redacted] of deficit-causing losses allocated to the limited partners in [redacted] should instead be allocated to the general partners. At the end of [redacted], [redacted] had no recourse debt and the limited partners did not have significant negative capital accounts. We do not have sufficient facts, including the precise status of partner capital accounts and partnership assets, to make the computation for [redacted]. Nonetheless, we have enough information about [redacted] to conclude that Treas. Reg. § 1.704-1(b)(3)(iii) would shift the losses to the general partners.

Specifically, we have information that the adjusted basis of [redacted] property approximated $[redacted] nonrecourse debt totaled $[redacted], and recourse debt totaled $[redacted].[11] If the partnership property were liquidated at its book value of $[redacted], $[redacted] of the proceeds would be used to pay

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11 This recourse amount includes $[redacted] of advances from and accounts payable to the general partners and entities controlled by the general partners.

off the priority nonrecourse debt. The remaining $[redacted] of proceeds would be applied to the subordinate recourse debt, leaving an additional $[redacted] of recourse debt to be covered by general partner contributions. Because this $[redacted] contribution obligation would exceed the $[redacted] deficit in limited partner capital accounts at the end of [redacted], clearly the general partners bore the economic burden of [redacted]'s deficit-inducing loss allocations.

Similar computations are required for subsequent years under Treas. Reg. § 1.704-1(b)(3)(iii).[12] As a result, loss allocations that increased limited partner deficit balances and were attributable, in effect, to recourse liabilities would be reallocated to the general partners. When considering the year in which the partnership property is ultimately sold, [redacted], the income allocations must account for the prior years' reallocations of losses. See Treas. Reg. § 1.704-1(b)(5), Example 15 (iii).

Outside of the precise computations required by Treas. Reg. § 1.704-1(b)(3)(iii), the more general partners'-interests-in-the-partnership determination would presumably reach the same reallocation result. The regulations clearly provide that the determination is made on an item-by-item basis. See Treas. Reg. § 1.704-1(b)(3)(i). The item being considered here is an annual loss allocation and, to the extent attributable to recourse debt, the proper recipients are the general partners. Cf. Treas. Reg. § 1.704-1(b)(4)(g) (loss allocations go to the partner that bears the burden of an economic loss). The overall factors listed in Treas. Reg. § 1.704-1(b)(3)(ii) are irrelevant here. See 3 A. Willis, J. Pennell & P. Postlewaite, Partnership Taxation § 102.02 at 102-4 (4th ed. 1989) ("Thus, it appears that in [cases in which an allocation lacks economic effect because of no deficit makeup] the risk of loss standard assumes paramount importance over the general four factors enumerated in the Regulations.").

The [redacted] submission dated [redacted] argues that the subject loss allocations are evaluated against the four overall factors listed in Treas. Reg. § 1.704-1(b)(3)(ii). Under this analysis, the limited partners retain their [redacted] percent share of losses. We note that for losses attributable to nonrecourse liabilities that do not satisfy the safe harbor in Treas. Reg. § 1.704-1(b)(4)(iv), an "overall" approach may be appropriate. See Treas. Reg. § 1.704-1(b)(4)(iv)(a) (last sentence). Our

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12 Beginning in [redacted], the nonrecourse debt becomes recourse because of the guarantee executed in that year. A consequence would be automatic reallocation of losses from the limited partners to the to the general partner or general partners, who would bear the economic burden of those losses. See Issue 1.

response to this position is that the subject losses are attributable to recourse liabilities, not nonrecourse liabilities.

Also in its submission of [redacted], [redacted] argues that allocations attributable to nonrecourse debt should be respected if the property's fair market value (rather than minimum gain) is sufficient to support an income chargeback upon disposition. The "marked-to-market" or "book-up" principle in Treas. Reg. § 1.704-1(b)(2)(iv)(r) supposedly supports this position. Although not technically contained in the regulations, the argument is not without merit. Nonetheless, we do not accept it because it undercuts the sensible stacking rule of Treas. Reg. § 1.704-1(b)(4)(iv)(c). This rule expressly accounts for the relative priorities of liabilities in evaluating allocations attributable to the liabilities.

F. Prior Law

The section 704(b) regulations are generally effective for partnership taxable years beginning after December 31, 1975. However, for the taxable years at issue here, an allocation will also be respected under section 704(b) if it has substantial economic effect or is in accordance with the partners' interests in the partnership as those terms have been interpreted under the relevant case law, the legislative history of the Tax Reform Act of 1976, and the regulations in effect for partnership taxable years beginning before May 1, 1986. Treas. Reg. § 1.704-1(b)(1)(ii).

These prior law authorities, particularly the cases, reinforce the capital accounts analysis embodied in the "economic effect" portion of the regulations (Treas. Reg. § 1.704-1(b)(2)(ii)(b).[13] Thus, subject to the discussion of nonrecourse liabilities in the next paragraph, if the [redacted] partnership agreement fails Treas. Reg. § 1.704-1(b)(2)(ii)(b)(2)

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[13] See Allison v. United States, 701 F.2d 933 (Fed. Cir. 1983); Gershkowitz v. Commissioner, 88 T.C. 984 (1987); Elrod v. Commissioner, 87 T.C. 1046 (1986); Ogden v. Commissioner, 84 T.C. 871 (1985), aff'd per curiam, 788 F.2d 252 (5th Cir. 1986); Goldfine v. Commissioner, 80 T.C. 843 (1983); Harris v. Commissioner 61 T.C. 770 (1974); Orrisch v. Commissioner, 55 T.C. 395 (1970), aff'd per curiam, (9th Cir. 1973); McGuffey v. Commissioner, T.C. Memo. 1989-267; Young v. Commissioner, T.C. Memo. 1987-397; Hirsch v. Commissioner, T.C. Memo. 1984-52; Frink v. Commissioner, T.C. Memo. 1984-669, rev'd and remanded on other issues sub nom. George v. Commissioner, 803 F.2d 144 (5th Cir. 1986); Dibble v. Commissioner, T.C. Memo. 1984-589; Miller v. Commissioner, T.C. Memo. 1984-336; Magaziner v. Commissioner, T.C. Memo. 1978-205.

(liquidation in accordance with positive capital accounts), prior law presumably will not benefit the partnership.

On the other hand, the subject loss allocations conceivably could be validated under prior law, based on [redacted]'s argument that the securing property always had enough value (and thus inherent unrealized gain) to cover the nonrecourse debt and eliminate deficit capital accounts. There seems to be no direct authority for this position, and we agree that Young v. Commissioner, T.C. Memo. 1987-397, may be cited in rebuttal. Nonetheless, we do not believe that the position is necessarily unreasonable under the principles that underlie the case law's capital accounts analysis. The [redacted] position on this issue is obviously more appealing if the partnership agreement is interpreted to require liquidation in accordance with positive capital accounts because the property's unrealized gain arguably satisfies the one remaining capital accounts deficiency (a deficit makeup obligation).

In sum, although [redacted]'s subject loss allocations apparently fail the economic effect requirement under Treas. Reg. § 1.704-1(b), the result is more uncertain under prior law principles, particularly because of a lack of direct authority. Despite a possible adverse decision, we do not believe that this case presents significant litigating hazards if the Service makes its primary arguments under the regulations and forces [redacted] to make its primary arguments under prior law.

If you have any questions concerning this matter, please contact Harve M. Lewis at FTS 566-4189.

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